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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

GARY PIERCE, Chairman
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SANDRA D. KENNEDY
PAUL NEWMAN
BRENDA BURNS

IN THE MATTER OF THE APPLICATION OF SOUTHWEST GAS CORPORATION FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS PROPERTIES THROUGHOUT ARIZONA.	Docket No. G-01551A-10-0458

Arizona Corporation Commission
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OPENING BRIEF OF

ARIZONA INVESTMENT COUNCIL

September 2, 2011

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INTRODUCTION

The Arizona Investment Council ("AIC"), on behalf of its approximately 6,000 members, including debt and equity investors in Southwest Gas Corporation ("Southwest Gas" or the "Company"), submits this Opening Brief.

AIC joins with the vast majority of the parties seeking approval of the Proposed Settlement Agreement (the "Settlement Agreement"). It was executed on July 15, 2011 by AIC, Southwest Gas, the Commission's Utilities Division Staff ("Staff"), the Southwest Energy Efficiency Project ("SWEEP"), Cynthia Zwick and the Natural Resources Defense Council ("NRDC").

The Settlement Agreement contains two "decoupling" proposals: Alternative A is a Lost Fixed Cost Recovery ("LFCR") mechanism and Alternative B is a revenue-per-customer decoupling ("Decoupling") mechanism. While AIC believes Alternative B's Decoupling proposal is the superior mechanism, AIC urges the Commission to approve the Settlement Agreement with the inclusion of either Alternative A or Alternative B in its entirety. After years of comprehensive research, analysis, debate and discussion, the Commission is now in a position to approve a decoupling mechanism that (1) incorporates more significant and aggressive ratepayer protections than those already approved in 22 other states[1] and (2) comports with the constitutional requirement to provide the Company a fair opportunity to earn its authorized rate of return.

THE RATE DESIGN PROBLEM

Under the current, traditional rate design, Southwest Gas is allowed to recover a portion (much less than half) of its fixed costs through the monthly service charge. The remainder of the

[1] Hr. Tr., Vol. II, p. 377, ll. 10-23.

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fixed costs which have been approved for recovery are incorporated into the per-therm rate. Accordingly, as customer usage decreases, the Company recovers less and less of its fixed costs. The result of this rate-design system? Not surprisingly, Southwest Gas has not earned its authorized rate of return for more than 15 years.[2]

Exacerbating this perpetual under-recovery are the newly-enacted Gas Utility Energy Efficiency Standards ("EE Standards"), which require Southwest Gas to reduce energy sales by another 6% by 2020. That requirement further constricts any chance the Company has even to cover fixed costs—much less to approach its authorized rate of return. The inherent conflict created by placing more than half of a utility's fixed costs in its per-therm rate and then mandating that it reduce gas sales is uniformly recognized.

Last December, the Commission acknowledged the conflict between demand-side management and recovery of fixed costs:

> Traditionally, Arizona's utilities have been disincented to vigorously utilize demand-side management programs to meet their resource needs. <u>An internal conflict exists for utilities between sales growth and promotion of programs</u> or technologies <u>which reduce sales</u>, as these sales offer the opportunity to recover fixed costs and earn profit; <u>sales erosion may impact recovery of fixed costs and investment returns</u>. To the degree...utility fixed costs are recovered from volumetric sales, a net lost revenue and profit erosion effect exists which could act as a disincentive to utilities robustly seeking to implement energy efficiency measures. <u>This utility disincentive to reduce sales discourages demand-side management programs which could ultimately benefit customers and minimize utility rates and customer utility bills</u>.[3]

Similarly, at hearing, witness after witness testified to the inherent disincentive and financial conflict exacerbated by the EE Standards:

[2] Hr. Tr., Vol. I, p. 87, ll. 13-18.
[3] Policy Statement, RUCO-1, p. 2. (Emphasis supplied.)

Steve Olea, Utilities Division Director, explained, "[T]he company is being mandated to conserve a certain amount. And if we assume that they are going to comply with the rules, which I assume all companies try to comply with all the rules, then they are going to sell that amount of gas less. And <u>if you know that, then they need to get compensated for that</u>."[4]

Barbara Keene, a public utilities analyst manager with the Utilities Division, stated, "[T]here is a disincentive for a utility to be required not to sell its product for any company. So, you know, although they always try to comply with Commission rules to the best of their ability, it becomes difficult when the requirements are so high."[5]

Ralph Cavanagh, the Energy Program Co-Director for the NRDC, testified to "the fundamental conflict of interest between the utility, viewed in terms of its shareholder interests, and the customers in terms of achievement of energy efficiency objectives, and in particular the Commission's objective to get all cost effective energy efficiency as quickly as possible."[6]

Jeff Schlegel, the Arizona representative for SWEEP, noted that "the company may want to help its customer, it may want to help customers reduce their bill, but each and every time they do it they get penalized with under-recovered fixed costs."[7]

Jodi Jerich, Director of the Arizona Residential Utility Consumer Office ("RUCO"), agreed that, under the current regulatory model, utilities have a financial disincentive to encourage customers to use less energy.[8]

THE SOLUTION—DECOUPLING

The solution to Southwest Gas's historic under-recovery problem—as now compounded by the EE Standards—lies in the Settlement Agreement. But, the process by which the solution was developed started long before this rate case was filed.

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[4] Hr. Tr., Vol. I, p. 213, l. 23 – p. 214, l. 3. (Emphasis supplied.)
[5] Hr. Tr., Vol. III, p. 524, ll. 13-17.
[6] Hr. Tr., Vol. II, p. 369, ll. 16-21.
[7] Hr. Tr., Vol. II, p. 479, l. 24 – p. 480, l. 2.
[8] Hr. Tr., Vol. III, p. 716, l. 3 – p. 717, l. 2.

Prior Rate Case and Generic Dockets

In 2004, Southwest Gas filed a rate case seeking a decoupling mechanism based on its "ongoing inability to achieve its authorized rate of return due, at least in part, to declining per customer usage on its system."[9] At that time, decoupling had only been approved in a handful of states[10] and the Company's proposal was opposed by Staff, SWEEP, NRDC and RUCO. Accordingly, the Commission recognized Southwest Gas's "increased financial pressure due to declining usage," but rejected the proposal and instead instructed the Company to coordinate discussions on the concept of decoupling.[11]

Responding to the Commission's directive, Southwest Gas worked with the parties, so by the time it filed its 2007 rate case, both SWEEP and NRDC endorsed the Company's decoupling proposal. However, Staff and RUCO remained opposed. Also, although a weather adjustor had been endorsed by several states,[12] decoupling was still being treated as a pilot program by many.[13] Three years ago, the Commission recognized decoupling had potential customer benefits and savings that should be explored in greater detail[14] and stated its expectation that the generic dockets would provide a workshop opportunity to explore decoupling and other viable alternatives.[15]

Witnesses for SWEEP and NRDC, who have spent many years analyzing decoupling throughout the country, described the workshops in those Commission dockets as "the most

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[9] Decision No. 68487, p. 31, ll. 15-18.
[10] *Id.*, p. 33, l. 20.
[11] *Id.*, p. 33, l. 26 – p. 34, l. 2 and p. 34, ll. 14-19.
[12] Decision No. 70665, p. 36, ll. 25-26.
[13] American Gas Association, 2008 Update on Revenue Decoupling Mechanisms (July 2008), <http://www.aga.org/SiteCollectionDocuments/RatesReg/Rate%20Alert/0807DECOUPUPDATE.PDF>.
[14] Decision No. 70665, p. 41, ll. 23-24.
[15] *Id.*, p. 41, ll. 17-18.

thorough going review of the issues surrounding disincentives to energy efficiency"[16] and "the most comprehensive review and opportunity for stakeholders to participate in the review of decoupling."[17] Following workshop conclusion, the Commission issued its Policy Statement endorsing decoupling and specifically stated a preference for full revenue-per-customer decoupling, i.e., the Settlement Agreement's Alternative B.[18]

Current Rate Case and Settlement Agreement

On November 12, 2010, Southwest Gas filed this rate case. After the parties exchanged direct testimony, they spent approximately three weeks in settlement discussions—the result of which is the Settlement Agreement that has been endorsed by all save one of the parties. But, as the foregoing demonstrates, the Settlement Agreement is not just the product of those recent negotiations. Instead, it culminates seven years' hard work, discussion, analysis and collaboration. Over that time, numerous parties, including Staff, have become supporters of decoupling as a mechanism that is fair to the Company and its customers and, as well, serves the best interests of the public.

Moreover, there have been significant developments supporting adoption of the decoupling proposals in the Settlement Agreement. First, the Settlement Agreement is responsive to and consistent with last December's Policy Statement. In fact, that is the "primary" reason for Staff's move from opposing decoupling in prior cases to supporting the Settlement Agreement.[19]

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[16] Hr. Tr., Vol. II, p. 361, ll. 3-4.
[17] Hr. Tr., Vol. II, p. 434, ll. 10-11.
[18] RUCO-1, p. 30, ¶ 4 and p. 31, ¶ 8.
[19] Hr. Tr., Vol. I, p. 170, l. 25 – p. 171, l. 19.

Second, decoupling is no longer a novel rate design concept. Fourteen states have approved it for electric utilities and 22 states have adopted it for natural gas utilities.[20] More than 40 natural gas utilities with more than 65 million residential customers currently operate with decoupled rates[21] and there is no evidence that decoupling has adversely impacted those customers.

To the contrary, Dr. Dan Hansen—the only witness who has actually studied the impact of decoupling on customers for regulators[22]—testified that, once decoupling was in place, the number of customer complaints decreased and customer satisfaction increased.[23] While there may be a vocal minority[24] who oppose the concept of decoupling (primarily due to misconceptions about how the mechanisms work), Dr. Hansen explained that he found "customer satisfaction improved" after decoupling was instituted.[25]

Southwest Gas's credit rating has also changed since its last rate case. But, the recent rating upgrade is primarily attributable to Nevada's approval of the Company's decoupling mechanism, as well as anticipation that decoupling will be approved by this Commission.[26] Significantly, one of the rating agency reports implied that rejection of decoupling in Arizona could lead to a downgrade of Southwest Gas's rating.[27] Even without a downgrade, a lack of

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[20] NRDC-1, p. 6, ll. 11-13.
[21] American Gas Association, Decoupling and Natural Gas Utilities Fact Sheet (August 2010), <http://www.aga.org/our-issues/RatesRegulatoryIssues/ratesregpolicy/Issues/Decoupling/Pages/default.aspx>.
[22] Though RUCO's witness, Dr. Ben Johnson, has expressed concerns about the potential negative impacts that decoupling could have on Arizona customers, he admittedly has not studied the impact that decoupling has had on customers in any state in which decoupling has been approved, because he "didn't see any particular purpose in that." Hr. Tr., Vol. III, p. 604, l. 15 – p. 606, l. 18.
[23] Hr. Tr., Vol. II, p. 267, l. 12 – p. 269, l. 6.
[24] According to the statistics reported by AARP Arizona during public comment, fewer than 1% of its members submitted comments opposing Southwest Gas's rate increase and/or decoupling proposal. Hr. Tr., Vol. I, p. 14, l. 18 and p. 18, ll. 11-18.
[25] Hr. Tr., Vol. II, p. 269, ll. 3-6.
[26] AIC-2, p. 3, ll. 12-17.
[27] Hr. Tr., Vol. II, p. 507, l. 14 – p. 508, l. 20.

decoupling will frustrate Southwest Gas's ability to attract investors,[28] which is a problem that the Company already faces because—according to at least one investment analyst—the Company's "below average" dividends means that "investors can probably find more attractive opportunities elsewhere."[29]

Settlement Agreement Consumer Protections and Benefits

Another key difference between this case and prior decoupling proposals is the Settlement Agreement's significant customer protections and benefits. During the Policy Statement workshops, Ms. Jerich, on behalf of RUCO, identified four essential elements she believed were necessary to any decoupler: cost effectiveness; a commitment to energy efficiency with identified goals; a high degree of accountability; and a cap on the amount of recovery.[30] At hearing, Ms. Jerich admitted that the Settlement Agreement incorporated each of these protections.[31]

Further, in RUCO's direct rate design testimony, its witness criticized the Company's proposed Decoupling mechanism on a number of bases, including the following: no restriction prohibiting the Company from earning more than its authorized rate of return between rate cases; lack of regulatory oversight between rate cases; and weakened incentive for the Company to minimize costs between rate cases.[32] But, every one of these concerns are addressed and resolved in the Settlement Agreement.

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[28] AIC-2, p. 3, l. 20 – p. 4, l. 2.
[29] RUCO-5.
[30] A-17.
[31] Hr. Tr., Vol. III, p. 726, l. 7 – p. 727, l. 9.
[32] RUCO-7, p. 22, ll. 19-22 and p. 23, ll. 8-10.

Specifically, under Alternative B, Southwest Gas is required to file quarterly reports detailing the bill impact of the Decoupling mechanism.[33] The Company is also required to file annual reports, including an earnings test that will prohibit it from recovering more than its authorized return on common equity.[34] The Company's annual report and earnings test will be the subject of an Open Meeting at which the Commission will regularly have the opportunity to determine whether the Decoupling mechanism should be suspended, terminated or modified.[35] Mr. Olea testified that the Commission's review and ability to eliminate the Decoupling mechanism each year is "more stringent than any other in the nation."[36] As to the Company's incentive to minimize costs, the Settlement Agreement requires Southwest Gas to reduce annual expenses by an average of $2.5 million.[37]

The customer protections built into Alternative B are also responsive to a statement recently issued by AARP Arizona. In fact, David Mitchell, the director of AARP Arizona, conceded during his public comment that Alternative B "comes closest" to incorporating the protections that AARP recommends.[38] As importantly, the two areas that Mr. Mitchell identified as shortcomings are actually misunderstandings on his part of Alternative B protections.

First, he expressed concern that the 5% cap increase should be lowered to an increase of 2-3% of base revenue.[39] However, as Mr. Schlegel explained, the 5% cap only applies to non-gas revenue, which means it actually does act as a 2.5% (or less) cap on the full bill or revenue amount.[40] Second, Mr. Mitchell objected to the five-year rate case moratorium, because

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[33] A-14, pp. 10-11, ¶¶ 3.21 and 3.22.
[34] A-14, pp. 11-13, ¶¶ 3.23 and 3.25-3.27.
[35] A-14, pp. 11-12, ¶ 3.24.
[36] Hr. Tr., Vol. I, p. 205, ll. 14-19.
[37] A-14, p. 20, ¶ 5.20.
[38] Hr. Tr., Vol. I, p. 16, ll. 20-22.
[39] Hr. Tr., Vol. I, p. 16, ll. 22-25.
[40] Hr. Tr., Vol. II, p. 437, ll. 8-19.

it would be too long for the Decoupling mechanism to be in place without an opportunity for review.[41] To the contrary and as explained above, the Settlement Agreement calls for annual reviews and potential modification or elimination of the mechanism, which more than sufficiently addresses this concern.

With regard to the rate case moratorium, RUCO expressed concern that the moratorium would harm ratepayers. But, as explained by Dr. Hansen, the moratorium actually benefits everyone except Southwest Gas:

> [T]he rate moratorium, as I see it, serves to benefit everyone except the utility, because the Commission has the ability, written into the settlement, each year to basically call off the decoupling mechanism and, with it, the rate moratorium. So if as a result of these annual reviews people decide that the utility's costs have gone down so much because of the improvement in the bond rating or in these reductions in operating cost that they don't like what is happening, they can basically end the rate moratorium by ending the mechanism. If things aren't going well [for the Company], if these cost changes don't work to the utility's favor, [Southwest Gas doesn't] have any similar ability to do that. They are still out for the five and a half years, approximately, for the amount of the rate moratorium.[42]

The adjustor mechanisms themselves also provide tangible consumer benefits. First, the weather component adjusts bills monthly to protect ratepayers from extreme winter weather events, which both Dr. Johnson and Ms. Jerich agree benefits customers.[43] Second, Mr. Olea explained that Alternative B's Decoupling mechanism benefits customers, because it completely removes Southwest Gas's disincentive to promote energy efficiency. It encourages the Company not only to meet the Commission's EE Standards, but to exceed them.[44] According to Dr. Hansen's studies for two regulatory commissions, adopting decoupling and removing the

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[41] Hr. Tr., Vol. I, p. 17, ll. 1-5.
[42] Hr. Tr., Vol. II, p. 349, ll. 6-21.
[43] RUCO-7, p. 26, l. 24 – p. 27, l. 6; Hr. Tr., Vol. III, p. 729, ll. 19-22.
[44] Hr. Tr., Vol. I, p. 244, ll. 15-17 and p. 245, ll. 14-16.

utility's disincentive to promote energy efficiency changes the way these companies operate[45]—they become energy efficiency partners with their customers, which translates into statistically significant energy savings and much lower customer bills.[46]

The Settlement Agreement also commits the Company to $1 million of shareholder funds to the Low Income Energy Conservation weatherization program.[47] That will help hundreds of low-income customers.[48] As Staff noted, these are the kinds of customer benefits provided by the Settlement Agreement that may not have been possible through a litigated case.[49]

Finally and significantly, in Ms. Jerich's review of some cases in which other commissions rejected decoupling, she did not find <u>any</u> case rejecting a mechanism that was accompanied by the host of consumer protections and benefits that are incorporated into this Settlement Agreement.[50] That's not surprising, given Mr. Cavanagh's testimony that the Settlement Agreement contains some of the "most aggressive" consumer protections he has ever seen.[51]

RUCO'S LACK OF A SOLUTION

The compromise offered by RUCO does not require much discussion. RUCO recommends increasing the fixed monthly charge by a little more than a dollar (from $10.70 to $11.85).[52] Under this proposal, the fixed monthly charge would still recover less than half of the Company's fixed costs. That would leave the remainder in the per-therm rate; cause fixed costs

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[45] Hr. Tr., Vol. II, p. 272, l. 2 – p. 273, l. 16.
[46] Hr. Tr., Vol. II, p. 265, l. 8 – p. 267, l. 3.
[47] A-14, p. 15, ¶ 4.1.
[48] Hr. Tr., Vol. II, p. 493, l. 8 – p. 495, l. 13.
[49] Hr. Tr., Vol. I, p. 174, l. 16 – p. 175, l. 1.
[50] Hr. Tr., Vol. III, p. 763, l. 24 – p. 764, l. 9.
[51] Hr. Tr., Vol. II, p. 377, ll. 10-23.
[52] RUCO-14, p. 10, ll. 12-14.

to be unrecovered; and provide no opportunity for the Company to achieve the rate of return this Commission says it should.

Not surprisingly, no one likes this proposal or believes it will solve Southwest Gas's persistent under-recovery—let alone encourage customers to reduce usage. Multiple witnesses, including Dr. Johnson, testified that increasing the monthly service charge will disproportionately impact low-usage customers (who often tend to be low-income customers) and will discourage consumer conservation and energy efficiency.[53] In fact, Dr. Johnson was very clear that the RUCO proposal is merely a reaction to the Settlement Agreement and that he does not endorse it as a stand-alone rate design recommendation.[54] As well, AARP Arizona opposes RUCO's proposal.[55]

CONSTITUTIONALITY

At hearing, the Administrative Law Judge requested briefing on the constitutionality of decoupling as an adjustor device. RUCO raised this issue in Southwest Gas's last rate case, citing *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612 (App. 1978).[56]

The court in *Scates* commented favorably on adjustment clauses—such as the decoupler or LFCR here—so long as they are adopted as part of the utility's rate structure in a full rate case in accord with statutory and constitutional requirements. The *Scates* Court's second concern was that the Commission's cost examination must be broad and must consider the effect of the adjustment on the utility's rate of return.

[53] Hr. Tr., Vol. III, p. 592, ll. 12-21. *See also* Hr. Tr., Vol. I, p. 175, l. 25 – p. 176, l. 18; Hr. Tr., Vol. II, p. 380, ll. 13-17.
[54] Hr. Tr., Vol. III, p. 617, ll. 11-21.
[55] Hr. Tr., Vol. I, p. 17, ll. 6-15.
[56] Decision No. 70665, p. 38, l. 25 – p. 39, l. 3.

As to the first requirement, these decoupling mechanisms clearly are being considered and adopted as part of the Company's rate structure in a full rate case. The adjustors have been formulated based on the Company's fixed costs as thoroughly reviewed and found by the Commission and its Staff to be just and reasonable in this rate case.[57] In this way, decoupling is similar to other adjustors routinely approved by the Commission.

On the second point, as Company witness Edward Giesking stated in his direct testimony, Alternative B's decoupler involves approved fixed costs per customer in the test year and will not result in the Company over-earning:

> Southwest Gas customers will benefit as a result of this change because it results in a cap being created on how much revenue per customer the Company is allowed to collect in rates. The Company will not be able to collect more revenue per customer than what the Commission authorizes in this rate case proceeding.[58]

Similarly, Alternative A's surcharge only allows the Company to recover lost revenues directly tied to its energy efficiency programs.[59]

Also, both Alternatives A and B require customer refunds in certain circumstances. Under Alternative B, if the authorized revenue per customer is exceeded, the Company will refund the entire amount of excess revenue without any cap.[60] Under Alternative A, in the event that the Company does not meet 100% of its required energy savings, customers will be issued a refund as well.[61]

Finally, the *Scates* decision discusses adjustors in terms of responding to exceptional situations. 118 Ariz. at 537, 578 P.2d at 617. Further, a case preceding *Scates* points out that

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[57] Hr. Tr., Vol. II, p. 354, ll. 13-21.
[58] A-12, p. 4, ll. 21-27.
[59] S-9, p. 9, ll. 24-26.
[60] A-14, p. 10, ¶ 3.20 and pp. 13-14, ¶ 3.29.
[61] A-14, p. 8, ¶ 3.6.

use of adjustors such as a decoupler are also appropriate because "a constant series of extended rate hearings are not necessary to protect the public interest." *Arizona Corporation Commission v. Arizona Public Service,* 113 Ariz. 368, 371, 555 P.2d 326, 329 (1976). The facts established in this rate case present precisely those circumstances as arguments for decoupling.

Southwest Gas has not earned its authorized rate of return since the last rate case concluded in December, 2008. In fact, it has not earned its authorized rate of return for more than 15 years, despite routinely filing for relief every three years.[62] Compounding this problem is the fact that, under the EE Standards, the Company is being <u>required</u> to sell less product, producing less fixed cost recovery. Therefore, it has no realistic opportunity to earn its authorized rate of return without a decoupling mechanism.[63] As Mr. Olea expressed numerous times during his testimony, if rates are set knowing that the utility will sell less gas, then something must be done to compensate the Company for this lost revenue.[64]

In light of these facts, not only do the Settlement Agreement's decoupler and LFCR fully comply with Arizona law, a strong argument exists that a <u>refusal</u> to authorize a decoupling mechanism is <u>violative</u> of *Scates* and other case law. As the Commission is well aware, it may not set rates that fail to meet the Company's operating costs and deprive it of a reasonable rate of return:

> Thus, the rates established by the Commission should meet the overall operating costs of the utility and produce a reasonable rate of return. It is equally clear that the rates cannot be considered just and reasonable if they fail to produce a reasonable rate of return . . .

Scates, 118 Ariz. at 534, 578 P.2d at 615.

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[62] Hr. Tr., Vol. I, p. 87, ll. 13-18.
[63] Hr. Tr., Vol. I, p. 86, l. 18 – p. 87, l. 3.
[64] Hr. Tr., Vol. I, p. 210, l. 6 – p. 211, l. 5 and p. 213, l. 16 – p. 214, l. 3.

CONCLUSION

Based on the foregoing, AIC urges the Commission to approve the Settlement Agreement, including either Alternative A or Alternative B in its entirety.

RESPECTFULLY SUBMITTED this 2nd day of September, 2011.

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